A NEW WAY TO EXPLAIN RISING INEQUALITY: How the expansion of US higher education has led to a more divided society!

During the 1980s, US wage inequality increased sharply while college education expanded strikingly. Are these two historical episodes unrelated? A new study by Theodore Koutmeridis, to be presented at the annual congress of the European Economic Association in Geneva in August 2016, shows that this is not a coincidence, as although desirable, the expansion of higher education has actually increased wage inequality.

His analysis establishes that when higher education expands, talented individuals acquire skills and abandon the pool of uneducated workers. This decreases unskilled-inexperienced wages and boosts inequality, highlighting that talent misallocation compresses wage dispersion. This unified theory is consistent with a combination of regularities in the data that cannot be explained easily by existing models, such as:

- the increase in the wage premium for having been to college despite the growing supply of skills;
- the understudied increase in the wage premium for experience;
- the sharp growth of the college premium for inexperienced workers and its moderate expansion for the experienced ones;
- and the puzzling coexistence of an increasing experience premium within the group of less educated workers and its flat pattern among the more educated ones.

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This research offers a new explanation for the rise in the wage premia for education and experience. In particular, the author underlines the perplexing fact that the education premium increases more for low-experienced workers, while the experience premium rises mainly for low-educated labour.

Intuitively, it seems that in the absence of experience, wage inequality is influenced more by education, while the lack of higher education allows experience to affect wage inequality more. This suggests that ability is revealed to firms either through formal education signals or with experience as employers observe and informally learn their workers’ talents.

The introduction of private employer learning in a model of education signalling with credit constraints explains these puzzling patterns. The combination of asymmetric information and credit constraints does not allow firms to distinguish the poor but able individuals from the less able ones, resulting initially in a pooling wage for all uneducated workers. But with experience, firms privately learn the type of their own employees, leading to different wage paths for uneducated workers, depending on their revealed ability-type.

When access to higher education increases, a larger fraction of talented individuals can acquire education and leave the uneducated pool. This implies that the group of uneducated young workers becomes of lower average quality, as most of the poor but able workers have now been plucked out of this group. In response, firms interpret lack
of college education as a clearer indication of low talent and offer lower wages to the remaining unskilled inexperienced workers, which boosts wage inequality.

This explanation fits US data from the Current Population Survey, indicating that for three decades, the rise in the education and experience premia coincided with falling unskilled-inexperienced wages, while skilled or experienced wages remained relatively flat. An important prediction that drives the main results of this study is the drop in the average ability of uneducated young workers.

The author corroborates the evidence related to wages using a rather different source, the National Longitudinal Survey of Youth, which includes observations related to the cognitive ability of individuals. This dataset also suggests that the average uneducated young worker is of lower ability nowadays compared with the past, which in turn explains the decrease in unskilled-inexperienced wages that boosted inequality, offering further supporting evidence.

Importantly, this research contributes to a topical debate related to the diverse sources of growing wage inequality. In particular, this new theory explains the patterns of wages in real terms, whereas the prevailing approach in the existing literature explains the shifts in wage levels only in relative terms based on the skill bias of technical change.

Furthermore, this new study suggests that changes in the composition of skills generate an important ‘quality effect’ that boosts the skill premium due to a decline in the quality of unskilled inexperienced workers, which outweighs the ‘quantity effect’ that moves to the opposite direction, as the increase in the relative supply of skilled labour tends to reduce the skill premium.

This quantity-quality trade-off offers a complementary explanation to the standard demand-supply race in the market for skills, which emphatically focuses on education and technology, ignoring other important aspects of the labour market, such as work experience or the role of asymmetric information.

Overall, this research highlights that talent misallocation compresses wage dispersion, while college expansion sorts better innate ability in education groups, leading to a more evident division of talents.

To put it differently, more easily accessible higher education allows inherent differences in talent to materialise in wage disparities in the actual distribution of labour income, generating a better-educated workforce but also a more divided society.

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‘Misallocation, Education Expansion and Wage Inequality’
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